A QUANTITATIVE AND ANALYTICAL STUDY OF ACCOUNTING PRINCIPLES

By

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This thesis is dedicated to my dear parents, Todd and Kristen Racine, who have passionately devoted their lives to the education and betterment of our youth. Their work continues to inspire thousands of students, and I am just one of them. I would not be the student, friend, or man I have become today without them.

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ABSTRACT

This thesis is a cumulative study of various accounting principles. Based on twelve unique case studies, these cases examine a wide array of accounting concepts and topics such as revenue recognition, stock-based compensation, fraud schemes, deferred income taxes, inventory analysis, and financial statement presentation. Data tested was directly sourced from the given circumstances within each case presented. Research done on principles and concepts was conducted through the use of the Financial Accounting Standards Board Codification, which is the singular source of rule and law for financial accounting. With respect to a summary of findings, there is not an all-inclusive conclusion or result of these studies, as each case presented is different with its own circumstances, data, and questions.

LIST OF FIGURES

Case Study 1

Home Heaters:

A Financial Accounting Study of Eads Heating, Inc. & Glenwood Heating, Inc.

APPENDIX I: FINANCIAL STATEMENTS FOR EADS HEATING, INC.

Eads Heating, Inc.
Income Statement
For Year Ended December 31, 20X1

Figure 1-1

Sales		398,500.00
Less: Cost of Goods Sold		(188,800.00)
Gross Profit		209,700.00
Operating Expenses		
Depreciation Expense	(41,500.00)	
Other Operating Expenses	(34,200.00)	
Bad Debt Expense	(4,970.00)	
Total Operating Expenses		80,670.00
Non-Operating & Other Income		
Interest Expense	(3,501.00)	
Total Non-Operating		(3,501.00)
Income Before Tax		94,020.00
Income Tax		(23,505.00)
Net Income After Taxes		70,515.00
Earnings Per Share		22.04

Eads Heating, Inc.
Statement of Cash Flows
For Year Ended December 31, 20X1

Figure 1-2

Cash Flows from Operating Activities		
Net Income		
Depreciation Expense	41,500.00	
Allowance for Bad Debts	4,970.00	
Accounts Receivable	(99,400.00)	
Inventory	(51,000.00)	
Accounts Payable	26,440.00	
Interest Payable	6,650.00	
Cash Used by Operating Activities		(70,840.00)
Net Cash Flows from Operating Activities		(325.00)
Cash Flows from Investing Activities		
Acquisition of Building	(350,000.00)	
Acquisition of Land	(70,000.00)	
Acquisition of Equipment	(80,000.00)	
Cash Used by Investing Activities		(500,000.00)
Net Cash Flows from Investing Activities		(500,000.00)
Common Stock Issuance	160,000.00	
Note Payable- Borrowing	380,000.00	
Payment of Dividends	(23,200.00)	
Principle of Lease- Payment	(8,640.00)	
Cash Used by Financing Activities		508,160.00
Net Cash Flows from Financing Activities		
Total Net Cash Flows		7,835.00

Eads Heating, Inc.
Classified Balance Sheet
For Year Ended December 31st, 20X1

Figure 1-3

Assets	
Current Assets	
Cash	7,835.00
Accounts Receivable	99,400.00
Inventory	51,000.00
Allowance for Bad Debts	(4,970.00)
Total Current Assets	153,265.00
Property, Plant & Equipment	
Building	350,000.00
Land	70,000.00
Equipment	80,000.00
Leased Equipment	92,000.00
Accumulated Depreciation - Leased Equipment	(11,500.00)
Accumulated Depreciation - Equipment	(20,000.00)
Accumulated Depreciation - Building	(10,000.00)
Total Property, Plant, & Equipment	550,500.00
Total Assets	703,765.00
Liabilities	
Current Liabilities	
Accounts Payable	26,440.00
Interest Payable	6,650.00
Total Current Liabilities	33,090.00
Long-Term Liabilities	
Lease Payable	83,360.00
Note Payable	380,000.00
Total Long-Term Liabilities	463,360.00
Total Liabilities	496,450.00
Stockholder's Equity	
Common Stock	160,000.00
Retained Earnings	47,415.00
Total Stockholder's equity	201,315.00
Total Liabilities & Equity	703,765.00

Eads Heating, Inc.
Statement of Changes in Stockholders' Equity
For Year Ended December 31st, 20X1

Figure 1-4

	Totals	Retained Earnings	Common Stock
Beginning balances	160,000.00	-	160,000.00
Net Income	70,515.00	47,315.00	-
Ending Balance	230,515.00	47,315.00	160,000.00

APPENDIX II: FINANCIAL STATEMENTS FOR GLEENWOOD HEATING, INC.

Glenwood Heating, Inc.
Income Statement
For Year Ended December 31st, 20X1

Figure 1-5

Sales		398,500.00
Less: Cost of Goods Sold		(177,000.00)
Gross Profit		221,500.00
Operating Expenses		
Rent Expense	(16,000.00)	
Depreciation Expense	(19,000.00)	
Other Operating Expenses	(34,200.00)	
Bad Debt Expense	(994.00)	
Total Operating Expenses		(70,194.00)
Non-Operating & Other Income		
Interest Expense	27,650.00	
Total Non-Operating		(27,650.00)
Income Before Tax		123,656.00
Income Tax		(30,914.00)
Net Income After Taxes		
Earnings Per Share		28.98

Glenwood Heating, Inc.
Statement of Cash Flows
For Year Ended December 31st, 20X1

Figure 1-6

Cash Flows from Operating Activities		
Net Income		92,742.00
Depreciation Expense	19,000.00	
Allowance for Bad Debts	994.00	
Accounts Receivable	(99,400.00)	
Inventory	(62,800.00)	
Accounts Payable	26,440.00	
Interest Payable	6,650.00	
Cash Used by Operating Activities		(16,374.00)
Cash Flows from Investing Activities		
Acquisition of Building	(350,000.00)	
Acquisition of Land	(70,000.00)	
Acquisition of Equipment	(80,000.00)	
Cash Used by Investing Activities		(500,000.00)
Cash Flows from Financing Activities		
Common Stock Issuance	160,000.00	
Note Payable- Borrowing	380,000.00	
Payment of Dividends	(23,200.00)	
Cash Used by Financing Activities		516,800.00
Total Net Cash Flows		426.00

Glenwood Heating, Inc.
Classified Balance Sheet
For Year Ended December 31st, 20X1

Figure 1-7

Assets	
Current Assets:	
Cash	426.00
Accounts Receivable	99,400.00
Inventory	62,800.00
Allowance for Bad Debts	(994.00)
Total Current Assets	161,632.00
Property, Plant & Equipment:	
Building	350,000.00
Land	70,000.00
Equipment	80,000.00
Accumulated Depreciation - Equipment	(10,000.00)
Accumulated Depreciation - Building	(9,000.00)
Total Property, Plant, & Equipment	481,000.00
Total Assets	642,632.00
Liabilities	
Current Liabilities	
Accounts Payable	26,440.00
Interest Payable	6,650.00
Total Current Liabilities	33,090.00
Long-Term Liabilities	
Note Payable	380,000.00
Total Long-Term Liabilities	380,000.00
Total Liabilities	413,090.00
Stockholder's Equity	
Common Stock	160,000.00
Retained Earnings	69,542.00
Total equity	229,542.00
Total Liabilities & Equity	642, 632.00

Glenwood Heating, Inc.
Statement of Changes in Stockholders' Equity
For Year Ended December 31^{st}, 20X1

Figure 1-8

	Totals	Retained Earnings	Common Stock
Beginning balances	160,000.00	-	160,000.00
Net Income	92,742.00	69,542.00	-
Ending Balance	252,742.00	69,542.00	160,000.00

APPENDIX III: RATIOS AND RATIO-BASED ANALYSES
EADS HEATING, INC.
Part A

Figure 1-9: Debt Ratio

Eads Heating, Inc.	Glenwood Heating, Inc.
70.54%	64.28%

Based on the debt ratio, Glenwood Heating, Inc. is most favorable. Through a computation that divides total debts by total assets, the conclusive percentages of Eads Heating, Inc. and Glenwood Heating, Inc. are 70.54 percent and 64.28 percent respectively. The favorability of Glenwood Heating, Inc. in this instance is attributed to its *lower* percentage of 64.2 percent, which indicates this company has a higher potential for longevity. A company with lower liabilities has lower overall debt. This is an attractive figure for potential investors who are in search of low-debt, high income-yielding companies.

Figure 1-10: Current Ratio

Eads Heating, Inc.	Glenwood Heating, Inc.
4.63:1	4.88:1

Based on the current ratio, Glenwood Heating, Inc. is more favorable. Through a proportional comparison of current assets to current liabilities, the conclusive ratios of Eads Heating, Inc. and Glenwood Heating, Inc. are 4.63:1 and 4.88:1 respectively. The favorability of Glenwood Heating, Inc. is attributed to its higher ratio of 4.88:1. This ratio indicates it is more liquid, thus proving its capability to pay off obligations when they come to their due dates.

Figure 1-11: Earnings Per Share

Eads Heating, Inc.	Glenwood Heating, Inc.
$22.04	$28.98

Based on the earnings per share of each company, via the income statement, Glenwood Heating, Inc. is more favorable. Through a computation that divides the after-tax income available to shareholders by the weighted average of common stock shares that are outstanding, the conclusive, per-share earnings of Eads Heating, Inc. and Glenwood Heating, Inc. are $22.04 and 28.98 respectively. The favorability of Glenwood Heating, Inc. is attributed to its higher earnings per share of $28.98. This indicates that Glenwood Heating, Inc. is capable of producing $6.94 per share more than Eads Heating, Inc., which provides shareholders with more valuable stock.

Figure 1-12: Gross Profit Margin

Eads Heating, Inc.	Glenwood Heating, Inc.
52.62%	55.58%

Based on the gross profit margin of each company, Glenwood Heating, Inc. is more favorable. Through a computation that subtracts cost of goods sold from revenue and then divides that amount by revenue, the conclusive percentages of Eads Heating, Inc. and Glenwood Heating, Inc. are 52.62 percent and 55.58 percent respectively. The favorability of Glenwood Heating, Inc. is attributed to its higher percentage of 55.58 percent. This indicates that Glenwood Heating, Inc. retains 2.96 percent more of its sales after it pays out cost of goods sold. For potential investors, a higher retention percentage of sale results in higher profits. In this case, Glenwood Heating, Inc. stands out as the most profitable company.

Conclusion of Analyses:

Based on the ratios presented above it appears that Glenwood Heating, Inc. reigns more profitable and less of a liability than Eads Heating, Inc. Barring the ratios, Glenwood holds a higher net income of $92,742.50 than Eads Heating, Inc., which is an attractive figure to potential investors. It would be the most financially sound decision to invest in Glenwood Heating, Inc. due to its lower debt, higher ability to pay off debts immediately, it’s higher retention of sales, and larger return on each share of stock.

APPENDIX IV: CHART OF ACCOUNTS
EADS HEATING, INC.
Part B

Figure 1-13

Asset Accounts	Dr.	Cr.
Cash	7,835.00	
Accounts Receivable	99,400.00	
Allowance for Bad Debts		4,970.00
Inventory	51,000.00	
Land	70,000.00	
Building	350,000.00	
Accumulated Depreciation- Building		10,000.00
Equipment	80,000.00	
Accumulated Depreciation- Equipment		20,000.00
Leased Equipment	92,000.00	
Accumulated Depreciation, Leased Equipment		11,500.00

Figure 1-14

Liability Accounts	Dr.	Cr.
Accounts Payable		26,440.00
Interest Payable		6,650.00
Notes Payable		380,000.00
Lease Payable		83,360.00

Figure 1-15

Equity Accounts	Dr.	Cr.
Retained Earnings		
Common Stock		160,000.00
Dividends	23,200.00	
Sales		398,500.00
Cost of Goods Sold	188,800.00	
Bad Debt Expense	4,970.00	
Depreciation Expense	41,500.00	
Other Operating Expenses	34,200.00	
Interest Expense	35,010.00	
Rent Expense		
Provision for Income Taxes	23,505.00	
TOTAL	1,101,420.00	1,101,420.00

APPENDIX IV: CHART OF ACCOUNTS
GLEENWOOD HEATING, INC.
Part B

Figure 1-16

Asset Accounts	Dr.	Cr.
Cash	426.00	
Accounts Receivable	99,400.00	
Allowance for Bad Debts		994.00
Inventory	62,800.00	
Building	350,000.00	
Land	70,000.00	
Accumulated Depreciation, Building		10,000.00
Equipment	80,000.00	
Accumulated Depreciation, Equipment		9,000.00
Leased Equipment		
Accumulated Depreciation, Leased Equipment		

Figure 1-17

Liability Accounts	Dr.	Cr.
Interest Payable		6,650.00
Accounts Payable		26,440.00
Notes Payable		
Lease Payable		380,000.00

Figure 1-18

Equity Accounts	Dr.	Cr.
Common Stock		160,000.00
Retained Earnings		
Dividends	23,200.00	
Sales		398,500.00
Cost of Goods Sold	177,000.00	
Bad Debt Expense	994.00	
Depreciation Expense	19,000.00	
Interest Expense	27,650.00	
Other Operating Expenses	34,200.00	
Rent Expense	16,000.00	
Provision for Income Taxes	30,914.00	
TOTAL	991,584.00	991,584.00

Case Study 2

Totz & Doodlez:

A Financial Accounting study of Totz & Doodlez. Inc.

Net Sales

References acquired:

Regulation S-X Rule 5-03
§ 210.5–03.1
§ 210.5–03.2
In reference to the FASB Codification, a database of all authoritative GAAP literature, Regulation S-X Rule 5-03 indicates that for companies with segmented additions, the net sales of each company must be listed as separate line items under the sales segment of the Income Statement. My team and I agree that the following amendment is relevant to the situation presented involving Totz and Doodlez. Specifically, the authoritative guidance says, "if income is derived from more than one of the sub captions described under § 210.5–03.1, each class, which is not more than 10 percent of the sum of the items, may be combined with another class. If these items are combined, related costs and expenses as described under § 210.5–03.2 shall be combined in the same manner."

1. Net sales and gross revenues. State separately:
    - (a) Net sales of tangible products (gross sales less discounts, returns and allowances)
    - (b) Operating revenues of public utilities or others;
    - (c) Income from rentals;
    - (d) Revenues from services; and
    - (e) Other revenues.

Further, my team and I have recognized the need of a comparative income statement due to the fluctuations of revenue between the years 2014, 2015, and 2016. This would be helpful when comparing the fluctuating revenue of each company and analyzing how each change has a dependent effect on revenues for Totz and its in-store segment Doodlez.

Gross Profit

References acquired:

360-20-55-14
225-10-s99-2 (number 2)
225-20-s99-8

In reference to ASC 360-20-55-14, "gross profit is presented as a separate item of revenue on the income statement when it is recognized as earned." Gross profit is an important component on the income statement, although it is not considered its own entity or section within the income statement, and is its own item. Further, ASC 225-10-299-2 (2) asserts, "2. costs and expenses applicable to sales and revenues: state separately the amount of (a) cost of tangible goods sold, (b) operating expenses of public utilities or others, (c) expenses applicable to rental income, (d) cost of services, and (e) expenses applicable to other revenues. The case states that deprecation is not included in cost of sales, and so therefore, cost of sales must be listed excluding depreciation according to ASC 225-20-s99-8.

Interpretive Response:

If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant, and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner, which results in reporting a figure for income before depreciation.

Gain on Sale of Corporate Headquarters

References acquired:

ASC 225-20-45-4

Totz Company abandoned and relocated their headquarters. Through this process, they sold their previous headquarters, which resulted in a gain of $1.7 million. My group and I have asserted that this transaction may not be listed as an extraordinary happening under the non-operating income portion of the income statement. Although this may be seen as an extraordinary occurrence, the sale of Totz's headquarters could have been a predictable occurrence if managers were to compare income and revenue data from past years and recognized growth. ASC 225-20-45-4 declares that:

> Certain gains and losses shall not be reported as extraordinary items (except as indicated in the following paragraph) because they are usual in nature or may be expected to recur as a consequence of customary and continuing business activities. Examples include all of the following:
>
> a. Write-down or write-off of receivables, inventories, equipment leased to others, deferred research and development costs, or other intangible assets.
> b. Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations.
> c. Gains or losses on disposal of a component of an entity
> d. Other gains or losses from sale or abandonment of property, plant, or equipment used in the business
> e. Effects of a strike, including those against competitors and major suppliers.

f. Adjustment of accruals on long-term contracts. (FASB Accounting Standards Codification)

<u>Class Action Statement</u>

References acquired:

FASB glossary reference 450-30-20
ASC 225-20-45-1
ASC 225-10-s99-2 (number seven)
ASU 225-20-65-1

Under the FASB glossary reference 450-30-20, a gain contingency is "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain to an entity that will ultimately be resolved when one or more future events occur or fail to occur." Due to an extraordinary occurrence, Totz was awarded a settlement amount of $2.7 million, which is to be considered a gain contingency. Furthermore, according to previous update 225-20-45-1, transactions and events should be presumed ordinary "unless the evidence clearly supports its classification as an extraordinary item as defined in this Subtopic." Despite this ASC, a new update 225-20-65-1 superseded the previous ASC and amended it- requiring that extraordinary items be no longer included in an income statement. My group and I have come to decide that this gain should be included under non-operating income due to its classification as a gain. Following the literature of ASC 225-10-s99-2 (number seven), items that are considered to be a part of non-operating income should be "stated separately in the income statement or in a note thereto amounts earned from (a) dividends, (b) interest on securities, (c) profits on securities (net of losses), and (d) miscellaneous other income.

My group and I find it significant to categorize this settlement in the non-operating income section of the income statement. We find this necessary due to the infrequency of awarded amount of $2.7 million. We believe a few notations should be considered: first, a note needs to be recorded to explain the gain shareholders will experience through this settlement. Secondly, it is important to notate that earnings per share will not be affected through this infrequent gain. The amount awarded of $2.7 million is still a substantial component to Totz's 2016 income and should be listed under Totz's non-operating income.

Case Study 3

Rocky Mountain Chocolate Factory:

A Financial Accounting Study of Rocky Mountain Chocolate Factory

Journal entries for Rocky Mountain Chocolate Factory:

Journal Entries

1	Raw material inventory	7,500,000.00	
	Accounts payable		7,500,000.00
2	Salary and wages expense	6,000,000.00	
	Wages payable		6,000,000.00
3	Cash	17,000,000.00	
	Accounts receivable	5,000,000.00	
	Sales		22,000,000.00
	Cost of goods sold	14,000,000.00	
	Inventory		14,000,000.00
4	Cash	8,200,000.00	
	Accounts payable		8,200,000.00
5	Cash	4,100,000.00	
	Accounts payable		4,100,000.00
6	Sales & marketing expenses	1,505,431.00	
	General & administrative expenses	2,044,569.00	
	Retail Operating expenses	1,750,000.00	
	Cash		2,000,000.00
	Expenses payable		3,300,000.00
7	Wages payable	6,423,789.00	
	Cash		6,432,789.00
8	Cash	125,000.00	
	Unearned revenue		125,000.00
9	Property, Plant, & Equipment	498,832.00	
	Cash		498,832.00
10	Retained Earnings	2,407,167.00	
	Cash		2,403,458.00
	Dividends payable		3,709.00

Adjusting Journal Entries

12	Cost of Sales	216,836.00	
	Inventory		216,836.00
13	Depreciation and Amortization	698,580.00	
	Property and Equipment, Net		698,580.00
14	General and Administrative	639,200.00	
	Retail Operating	6,956.00	
	Accrued Salaries and Wages		646,156.00
15		N/A	
			N/A

Closing Journal Entries

16	Sales	22,944,017.00	
	Franchise and Royalty fees	5,492,531.00	
	Interest Income	27,210.00	
	Income Summary		28,463,758.00
	Income Summary	24,883,681.00	
	Cost of Sales		14,910,622.00
	Franchise Costs		1,499,477.00
	Sales and Marketing		1,505,431.00
	General and Administrative		2,422,147.00
	Retail Operating		1,756,956.00
	Depreciation and Amortization		698,580.00
	Income Tax Expense		2,090,468.00
	Income Summary	3,580,077.00	
	Retained Earnings		3,580,077.00

APPENDIX V: ROCKY MOUNTAIN CHOCOLATE FACTORY CHARTS

Figure 3-1: Rocky Mountain Chocolate Factory Unadjusted Entries

		Beginning Balance (February 28, 2009)	JE1. Purchase inventory	JE 2. Incur Factory Wages	JE 3. Sell inventory for cash and on account	JE 4. Pay for inventory	JE 5. Collect receivables	JE 6. Incur SG&A (cash and payable)	JE 7. Pay wages	JE 8. Receive franchise fee	JE 9. Purchase PPE	JE 10. Dividends declared and paid	JE 11. All othr transactions	Unadjusted Trial Balance
Dr.	Cash and Cash Equivalents	1,253,947			17,000,000	-8,200,000	4,100,000	-2,000,000	-6,423,789	125,000	-498,832	-2,403,458	790,224	3,743,092
	Accounts Receivable	4,229,722			5,000,000		-4,100,000						-702,207	4,427,515
	Notes Receivable, current	-											91,059	91,059
	Inventories	4,064,611	7,500,000	6,000,000	-14,000,000								-66,328	3,498,283
	Deferred Income Taxes	369,197											92,052	461,249
	Other	224,378											-4,215	220,163
	Property and Equipment, Net	5,253,598									498,832		132,859	5,885,289
	Notes Receivable, less current portion	124,452											139,198	263,650
	Goodwill, net	1,046,944												1,046,944
	Intangible Assets, net	183,135											-73,110	110,025
	Other	91,057											-3,007	88,050
Cr.	Accounts Payable	1,074,643	7,500,000			-8,200,000							503,189	-877,832
	Accrued Salaries and Wages	423,789		6,000,000					-6,423,789				-	-
	Other Accrued Expenses	531,941						3,300,000					-2,885,413	946,528
	Dividend Payable	598,986										3,709	-1	602,694
	Deferred Income	142,000								125,000			-46,062	220,938
	Deferred Income Taxes	827,700											66,729	894,429
	Common Stock	179,696											1,112	180,808
	Additional Paid-in-Capital	7,311,280											315,322	7,626,602
	Retained Earnings	5,751,017										-2,407,167		3,343,850
	Sales	-			22,000,000								944,017	22,944,017
	Franchise and Royalty Fees	-											5,492,531	5,492,531
Dr.	Cost of Sales	-			14,000,000								693,786	14,693,786
	Franchise Costs	-											1,499,477	1,499,477
	Sales & Marketing	-						1,505,431					-	1,505,431
	General and Administrative	-						2,044,569					-261,622	1,782,947
	Retail Operating	-						1,750,000					-	1,750,000
	Depreciaton and Amortization	-											-	-
	Interest Income	-											-27,210	-27,210
	Income Tax Expense	-											-2,090,468	-2,090,468
	A=L+OE+R-E	0	0	0	0	0	0	0	0	0	0	0	0	0

Figure 3-2: Rocky Mountain Chocolate Factory Unadjusted Trial Balance Spreadsheet

		Unadjusted Trial balance	Adjust for Inventory Count	Record Depreciation	Wages Accrual	Pre-closing Trial Balance	Closing Entry	Post-closing (ending) balance	Actual February 28th, 2010 F/S Figures
Dr.	Cash and Cash Equivalents	3,743,092				3,743,092		3,743,092	3,743,092.00
	Accounts Receivable	4,427,526				4,427,526		4,427,526	4,427,526.00
	Notes Receivable, current	91,059				91,059		91,059	91,059.00
	Inventories	3,498,283	- 216,836			3,281,447		3,281,447	3,281,447
	Deferred Income Taxes	461,249				461,249		461,249	461,249
	Other	220,163				220,163		220,163	220,163
	Property and Equiptment, Net	5,885,289		- 698,580		5,186,709		5,186,709	5,186,709
	Notes Receivable, less current portion	263,650				263,650		263,650	263,650
	Goodwill, net	1,046,944				1,046,944		1,046,944	1,046,944
	Intangible Assets, net	110,025				110,025		110,025	110,025
	Other	88,050				88,050		88,050	88,050
Cr.	Accounts Payable	877,832				877,832		877,832	877,832
	Accrued Salaries and Wages	-			646,156	646,156		646,156	646,156
	Other Accrued Expenses	946,528				946,528		946,528	946,528
	Dividend Payable	602,694				602,694		602,694	602,694
	Deferred Income	220,938				220,938		220,938	220,938
	Deferred Income Taxes	894,429				894,429		894,429	894,429
	Common Stock	180,808				180,808		180,808	180,808
	Additional Paid-in-Capital	7,626,602				7,626,602		7,626,602	7,626,602
	Retained Earnings	3,343,850				3,343,850	3,580,077	6,923,927	6,923,927
	Sales	22,944,017				22,944,017	- 22,944,017.00	-	22,944,017
	Franchise and Royalty Fees	5,492,531				5,492,531	- 5,492,531	-	5,492,531
Dr.	Cost of Sales	14,693,786	216,836			14,910,622	- 14,910,662	-	14,910,622
	Franchise Costs	1,499,477				1,499,477	- 1,449,477	-	1,499,477
	Sales & Marketing	1,505,431				1,505,431	- 1,505,431	-	1,505,431
	General and Administrative	1,782,947			639,200	2,422,147	- 2,422,147	-	2,422,147
	Retail Operating	1,750,000			6,956	1,756,956	- 1,756,956	-	1,756,956
	Depreciaton and Amortization	-		698,580		698,580	- 698,580	-	698,580
	Interest Income	- 27,210				- 27,210	27,580	-	- 27,210
	Income Tax Expense	2,090,468				2,090,468	- 2,090,468	-	2,090,468
	A=L+OE+R-E								

APPENDIX VI: ROCKY MOUNTAIN CHOCOLATE FACTORY FINANCIAL STATEMENTS

Rocky Mountain Chocolate Factory

Unadjusted Trial Balance

Figure 3-3

Account	Dr.	Cr.
Cash and Cash Equivalents	3,743,092.00	
Accounts Receivable	4,427,526.00	
Notes Receivable, net	91,059.00	
Inventories	3,498,283.00	
Deferred Income Taxes	461,249.00	
Other Current Assets	220,163.00	
Property and Equipment, Net	5,885,289.00	
Notes Receivable, less current portion	263,650.00	
Goodwill, net	1,046,944.00	
Intangible Assets, net	110,025.00	
Other Long-Term Assets	88,050.00	
Accounts Payable		877,832.00
Accrued Salaries and Wages		-
Other Accrued Expenses		946,528.00
Dividend Payable		602,694.00
Deferred Income		220,938.00
Deferred Income Taxes		894,429.00
Common Stock		180,808.00
Additional Paid-In-Capital		7,626,602.00
Retained Earnings		3,343,850.00
Sales		22,944,017.00
Franchise and Royalty Fees		5,492,531.00
Cost of Sales	14,693,786.00	
Franchise Costs	1,499,477.00	
Sales & Marketing	1,505,431.00	
General and Administrative	1,782,947.00	
Retail Operating	1,750,000.00	
Depreciation and Amortization		
Interest Income		(27,210.00)
Income Tax Expense	2,090,468.00	
Total	43,157,439.00	43,103,019.00

Rocky Mountain Chocolate Factory, Inc.
Income Statement
For Year Ended February 28th, 2010

Figure 3-4

Revenues	
Sales	22,944,017.00
Franchise and Royalty Fees	5,492,531.00
Total Revenue	28,436,548.00
Cost and Expenses	
Cost of Sales	14,910,622.00
Franchise Costs	1,499,477.00
Sales & Marketing	1,505,431.00
General & Administrative	2,422,147.00
Retail Operating	1,756,956.00
Depreciation and Amortization	698,580.00
Total Costs and Expenses	22,793,213.00
Operating Income	5,643,335.00
Other Revenues and Expenses	
Interest Income	(27,210.00)
Income Before Taxes	5,616,125.00
Income Tax Expense	2,090,468.00
Net Income	3,525,657.00

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
February 28, 2010

Figure 3-5

Assets	
Current Assets	
Cash	3,743,092.00
Accounts Receivable	4,427,526.00
Notes Receivable, Current	91,059.00
Inventories	3,281,447.00
Deferred Income Taxes	461,249.00
Other	220,163.00
Total Current Assets	12,224,536.00
Property and Equipment, net	5,186,709.00
Other Assets	
Notes Receivable, less current portion	263,650.00
Goodwill, net	1,046,944.00
Intangible Assets, net	110,025.00
Other Long Term Assets	88,050.00
Total Other Assets	1,508,669.00
Total Assets	18,919,914.00
Liabilities and Stockholders' Equity	
Current Liabilities	
Accounts Payable	877,832.00
Accrued Salaries and Wages	646,156.00
Other Accrued Expenses	946,528.00

Dividend Payable	602,694.00
Deferred Income	220,938.00
Total Current Liabilities	3,294,148.00
Deferred Income Taxes	894,429.00
Stockholders' Equity	
Common Stock	180,808.00
Additional Paid-In-Capital	7,626,602.00
Retained Earnings	6,923,927.00
Total Stockholders' Equity	14,731,337.00
Total Liabilities and Stockholders' Equity	18,919,914.00

Case Study 4

Fraudulent Schemes:

A Financial Accounting Analysis of Fraud Schemes and Internal Controls

Fraud Scheme	Internal Control
Lack of a time clock enables employees to lie about the time they have worked.	Technology Update: An online program/software should be implemented to record and time hours worked (suggestion: Paycom.com).
An employee accepts a check for merchandise and completely bypasses the electronic system.	Physical Audit: A physical count of inventory should be done periodically to make sure sales and ending inventory match total inventory.
Since there is not a physical inventory count and all employees have authority to enter all types of transactions, an employee can make a sale and then create a false return right after and pocket the cash from the sale.	Separation of Duties: There should be only one employee authorized to make returns during the shift. Approval Authority: All employees are able to make returns but must first have approval from a manager to create this transaction. Physical Audits: A physical count of inventory and cash should be taken. Cash should be done on a daily basis; depending on size of the store, inventory counts can be done less frequently—monthly or quarterly.
During a transaction, a discount is added to the full price for customer to pay. The system shows entire price recorded, but the employee pockets difference between full price and full price plus the discount that the customer pays.	Physical Audit: There should be a physical count of cash at the end of an employee's shift. Cash sales and credit sales should equal the amount of cash and total for credit card transactions, respectively.
Lack of security measures make it easy for employees to steal merchandise.	Physical safeguards: Cameras, locks, and sensors can be used to ensure that all merchandise taken outside of the store is paid for. Additionally, it adds to the safety of employees and merchandise in the case of a robbery.

The business is running on a simple accounting software.	Technology update: Using a more advanced accounting system can more accurately pinpoint and track discrepancies. In light of expansion, a more advanced system in necessary.
Lucy handles minor customer complaints. She could fake a complaint asking for a refund and then pocket the money for the refund.	Separation of Duties: There should be more than one person handling complaints and customer service. A suggested pipeline is delegating complaints and customer service to an experienced employee. This employee will forward the issue along with a solution to the manager who either approves or declines the suggestion. Upon approval, the store owner will send an email to the customer inquiring if the customer service was handled correctly and satisfying.
Employees can disguise fraud by using another employees access code to the register.	Access Controls: Each employee's code to the register should be changed periodically to ensure they are kept unique and secret. Separation of Duties: Authorize only two employees to create transactions during the shift and designate them to a specific register. This places the responsibility of each register reconciling on one employee.
Lucy has access to the accounting system and thus the inventory system; she can alter the inventory to cover up discrepancies in sales and the electronic inventory count.	Access Controls: Passwords should be implemented to access different parts of the accounting system. Not only does it keep unauthorized users out of the system but makes it easier to identify the source of error or discrepancy.
Employees are authorized to enter all types of transactions.	Approval Authority: Transactions of a large dollar amount or transactions that require a large amount of cash change being given back to the customer should be required to have manager approval before occurring.
Lucy summarizes and records daily sales in the accounting system and prepares bank deposits.	Separation of Duties: The job of reporting and depositing should be separated to lessen the chance of fraud.

Case Study 5

An Analysis of Inventories

A Financial Accounting Analysis of Inventory

1. Cost Components of Inventory
    a. Components of Raw Material:
        i. Storage
        ii. Spoilage
        iii. Maintenance
        iv. Purchases
        v. Procurement
    b. Components of Work in Process
        i. Storage
        ii. Spoilage
        iii. Labor costs
    c. Components of Finished Goods
        i. Storage
        ii. Spoilage
        iii. Reworking
        iv. Freight out
        v. Maintenance
2. Inventories are net of an estimated allowance for obsolete or unmarketable inventory
3. Allowance for obsolete or unmarketable inventory:
    a. This account belongs on the balance sheet
    b. The gross amount of inventory at the end of the last two years is $467,494
    c. The portion of the reserve could be attributable to the three types of inventory;
        i. Raw Materials: could include damaged or bad supplies
        ii. Work in Process: could include products not made correctly
        iii. Finished goods: could include damaged or spoiled goods

4. Journal entries prepared to record activity in the reserve for obsolete inventory:

Cost of Goods Sold	13,348,000.00	
Inventory		13,348,000.00
Write-off, disposal	13,348,000.00	
Inventory		13,348,000.00

5. Journal entries:

Raw Materials

46,976	
84388	
	87,995
43,469	

Finished Goods

184,808	13,348
214,565	218,316
167,646	

Cost of Sales

184,808	13,348
214,565	218,316
167,646	

Work in Process

1,286	
126,000	
87,895	
	214,505
619	

Accounts Payable

84,388	39,012
	45,376

6. The company’s inventory turnover ratio for the year 2012 was 2.63. The company’s inventory turnover ratio for the year 2011 was 2.29.
7. For the year 2012, the inventory holding period was 129 days. For the year 2011, the inventory-holding period was 159 days. Conclusively, the company is becoming more efficient because the days of holding inventory reduced from year 2011 to year 2012 by 30 days.
8. For 2012, the percent of finished goods that the company estimated as obsolete was 17.91%. For the year 2011, the percentage was 22.58%. In terms of additional information, my team and I decided it would be beneficial to present more ratios.

Case Study 6

WorldCom, Inc.:

A Financial Accounting Study of Capitalized Costs and Earnings Quality

A. An asset is something of tangible or intangible matter that brings future value to the respective owner. Its value can be depleted or depreciated over time depending on what type of asset category it falls under. Assets on financial statements are listed in order of liquidity from most liquid to least liquid. Some examples of assets are cash, inventory, prepaid insurance, patents, trademarks, property, plant, and equipment, and short-term investments. Expenses are outflows of money. There are many types of expenses such as operating expenses, depreciation expenses, and inventory expenses.

B. After their initial capitalization, costs become part of the cost of an asset. In the event that the decision is made to capitalize a cost, the balance sheet and income statement are affected. With respect to the balance sheet, assets will be higher if costs are capitalized. With respect to the Income Statement, the main affect will be a decrease in Net Income. The reasoning behind this is because later in the company's life, it's profitability will decrease more than if the company had chosen to expense it instead.

C.

Line Costs (exp.)	14,739,000,000	
Cash		14,739,000,000

The types of costs that were improperly capitalized were transmission equipment, communications equipment, and construction in progress.

D.

PPE	3,055,000,000	
Line Costs		3,055,000,000

E.

	Years	Quarter	Depreciation Expense
$771,000,000.00	22	1	$35,045,454.55
$610,000,000.00	22	3/4	$20,795,454.55
$743,000,000.00	22	1/2	$16,886,363.64
$931,000,000.00	22	1/4	$10,579,545.45
			$83,306,818.18

Depreciation Expense	83,306,818	
Accumulated Depreciation		83,306,818

F.

Income before taxes, as reported	$2,393,000,000.00
Add back depreciation for the year from part F	$35,045,454.55
Deduct Line costs that were improperly capitalized	$-3,055,000,000.00
Loss before taxes, restated	$-578,693,181.82
Income tax benefit	$202,542,613.64
Minority Interest	$35,000,000.00
Net loss, restated	$-341,150,568.18

Case Study 7

Targa Company:

A Financial Accounting Study of Nonretirement Postemployment Benefits and Relocation

Executive Summary

This study of Nonretirement Postemployment Benefits and Relocation Costs was formulated and analyzed in accordance with U.S. GAAP provided within the FASB Codification.

Targa Co. is a company that is beginning to restructure a business line. Currently, it is going to move a manufacturing operation to a new location in another geographic area.

With respect to special termination benefits, it has been concluded that special termination benefits to employees will be recorded as a liability and loss. The acceptance of these benefits and contingencies per the employees have not yet been provided; thus, according to the FASB guidance, a specified date of recognition cannot yet be stated.

With respect to the one-time employee termination benefit, Targa should recognize a liability of $2,500,000 at the communication date of December 27, 20X, since ASU 420-10-30-6 states that a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date.

With respect to the recognition of termination benefits, Targa has already indicated that the facility manager will receive a lump-sum of $50,000, Targa Co. should recognize the liability for the year ended December 31, 20X1. This assertion is supported through ASC 712-10-25-2.

With respect to relocation and employee training costs, both the relocation cost and staff training cost will not be considered liabilities. This is supported under the premise of ASC §420-10-25-2 which states that an exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability. Targa Co. has only provided an exit plan, and has not stated any potential occurrence of obligations originating from the borrowing of funds.

Nonretirement Postemployment Benefits

References acquired:

§420-10-25-1
§420-10-25-4
§712-10-20
§712-10-25-1
§712-10-25-2
§420-10-30-6

Before providing guidance towards the recognition of nonretirement postemployment benefits, the definition, pertaining to nonretirement postemployment benefits, must be stated. According to the FASB glossary, nonretirement postemployment benefits are all types of benefits, other than those provided through a pension or other postretirement plan provided to former or inactive employees, their beneficiaries, and covered dependents. Employees of the Plant A facility can be interpreted to be inactive employees, which are defined as employees who are not currently rendering service to the employer and who have not been terminated. They include those who have been laid off and those on disability leave, regardless of whether they are expected to return to active status. Since Plant A is being discontinued, it is fair to assume no services are being rendered as the company goes through the restructuring process.

Furthermore, in the case of Targa Co., benefits consistent with what the Codification considers to be one-time employee termination benefits, are being offered. By definition, one-time employee termination benefits are benefits that are offered to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement for short period of time in exchange for employees' voluntary termination of service. This definition is in accordance with ASC 420-10-20. The qualifications for one-time employee termination benefits follow:

- Management, having the authority to approve the action, commits to a plan of termination.
- The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.
- The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Targa has successfully identified the stated conditions above.

Targa also offers a 2-week severance benefit offered to non-volunteering, terminated employees, which is classified as a special termination benefit. The definition of a special termination benefit is defined as benefits that are offered for a short period of time in exchange for employees' voluntary termination of service, as referenced in ASC 712-10-20.

Interpretive Response and Analysis:

Referencing the FASB Codification, Accounting Standard Concept 712-10-25 provides guidelines pertaining to the termination of employees and contractual employees and the recognition of benefits assigned to complying employees. Accredited to subsection 25-1, the FASB guidance follows: nonretirement postemployment benefits offered as special termination benefits to employees shall be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. Although ASC 712-10-25 refers specifically to special termination benefits, which applies to the $500,000, the acceptance of these benefits and contingencies per the employees have not yet been provided; thus, according to the FASB guidance, a specified date of recognition cannot yet be stated.

Unique guidance applies to the one-time employee termination benefits of $2,500,000 pertaining to the timing of recognition.

The recognition of one-time employee termination benefits is supported in ASC 420-10-25-1, which states that a liability for a cost associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred. According to ASC 420-10-25-5, an entity's communication of a promise to provide one-time employee termination benefits is a promise that creates an obligation at the communication date to provide the termination benefits if employees are terminated. Therefore, Targa should recognize a liability of $2,500,000 at the communication date of December 27, 20X1 since ASC 420-10-30-6 states that if employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date.

With credit to ASC 712-10-25-2, which refers specifically to the recognition of termination benefits attributed to contracted employees, an employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump-sum payments and the present value of any expected future payments. Targa Co. is offering the facility manager a one time, lump-sum benefit of $50,000. Since Targa has already indicated that the facility manager will

receive a lump-sum of $50,000, Targa Co. should recognize the liability for the year ended December 31, 20X1.
Relocation Costs

References acquired:

§420-10-15-4
§420-10-25-2

The activity that Targa Co. is performing is specified as corporate restructuring. Under §420-10-15-4, the term 'exit activity' is an umbrella term that encapsulates corporate restructuring. This ASC classified a restructuring as such as the sale or termination of a line of business, the closure of business activities in a particular location, the relocation of business activities from one location to another, changes in management structure, and a fundamental reorganization that affects the nature and focus of operations.

In terms of measurement, both the relocation cost and staff training cost will not be considered liabilities. This is supported under the premise of ASC §420-10-25-2, which states that an obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability. Targa Co. has provided an exit plan, but when referring to the costs incurred to relocate and train staff, Targa Co. will not owe an entity any amount of money unless borrowed. The information provides no indication that funds will be borrowed to cover any costs pertaining to exiting

Case Study 8

Merck Equity:

A Financial Accounting Study of Merck Equity

1. Consider Merck's common shares:
    - How many common shares is Merck authorized to use?
        - Answer: Merck is authorized to use 5,400,000,000
    - How many common shares has Merck actually issued at December 21, 2007?
        - Answer: Merck issues 2,983,508,675
2. Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet.
    - Answer: 2,983,508,675 * $0.01= 29,835,086.75
3. How many common shares are held in treasury at December 31, 2007?
    - Answer: 811,005,791
4. How many common shares are outstanding at December 21, 2007?
    - Answer: 2,983,508,675 – 811,005,791= 2,172,502,884 shares
5. At December 31, 2007, Merck's stock price closed at $57.61 per share. Calculate the total market capitalization of Merck on that day.
    - Answer: 2,172,502,884 * $57.61 = $125,157,891,000 billion
6. Why do companies pay dividends on their common or ordinary shares? What normally happens to a company's share price when dividends are paid?
    - Companies typically pay dividends to give part of their earnings back to investors, and the stock price normally drops after the company pays dividends. This can be seen as a reward to investors.
7. In general, why do companies repurchase their own shares?
    - Companies will repurchase their own shares to retain control of their organization.
8. Consider Merck's statement of cash flow and statement of retained earnings. Prepare a single journal entry that summarizes Merck's common dividend activity for 2007.

Retained Earnings	39,140,000	
Dividends Payable		4,200,000
Cash		34,940,000

9. During 2007, Merck repurchased a number of its own common shares on the open market.
    - Describe the method Merck uses to account for its treasury stock transactions.
        - The cost method because treasury stock is recorded at cost.
    - Refer to note 11 to Merck's financial Statements. How many shares did Merck repurchase on the open market during 2007?
        - Merck repurchased 26,500,000 shares on the open market during 2007.
    - How much did Merck pay, in total and per share on average, to buy back its stock during 2007? What type of cash flow does this represent?

    - He paid 1,429,700,000. Per share is valued at $53.9 which was calculated by dividing total cost bought back by the number of shares purchased. This is a financing cash flow activity.
- Why does Merck disclose its treasury stock as an asset?
    - He counts it as an asset because it provides no future economic benefit and will not lead to future cash flows.

10.

Merck ($)

(in millions)	2007	2006
Dividends Paid	3,307,300,000.00	3,322,600,000.00
Shares Outstanding	2,172,502,884.00	2,423,776,663.00
Net Income	3,275,400,000.00	4,433,800,000.00
Total Assets	48,350,700,000	44,569,800,000
Operating Cash Flows	6,999,200,000.00	6,765,200,000.00
Year-end stock price	$57.61	$41.94
Dividends Per Share	1.52	1.37
Dividend Yield	2.64%	3.27%
Dividend Pay Out	1	0.75
Dividends to Total Assets	68.40%	74.50%
Dividends to Operating Cash Flows	47.25%	49.11%

Case Study 9

Xilinx, Inc.—Stock-Based Compensation:

A Financial Accounting Study of Stock-Based Compensation

Concept A

One of Xilinx's equity incentive plans is its employee stock option plan discussed in Notes 2 and 6. Explain, in your own words, how this plan works. What incentives do stock option plans such as this one provide to employees?

Response:

The employee stock option plan is a plan in which employees can be compensated with company stock instead of being compensated with cash. The main incentive is that it incentivizes the performance of the employees, since their performance is directly correlated with the stock price.

Concept B

Xilinx also discusses the use of restricted stock units, also called RSUs (on page 63 of Xilinx's annual report). RSUs are grants valued in terms of Xilinx stock, but Xilinx does not issue the stock at the time of the grant. Upon satisfying the vesting requirements, Xilinx distributes to employees either shares or the cash equivalent of the number of shares used to value the unit. Compare the use of RSUs and stock options as a form of incentive compensation to employees. Why might companies offer both types of programs to employees?

Response:
Restricted Stock Units are simply shares of common stock. When granted an RSU, an employee does not automatically receive stock and it is instead contingent on the vesting plan that is created. This vesting plan is based upon a performance and time contingency per individual employee. Typically, the vesting period is a two-year period in which at the end an employee will be eligible to receive an allotted amount of the RSUs that they were granted. Vesting terms are variable on a per-employee basis.

Response (continued under Concept B):

Stock options, on the other hand, are forms of compensation granted to employees that qualifies them to either accept the option or to not exercise the option. If an employee decides to exercise a stock option, they also have the right to buy or sell the stock at an agreed upon price upon a given period of time. It is common practice that a contract for stock options is representative of 100 underlying shares or less and have two parties involved. In the particular case of employee stock options, the contract with the employee is based upon vesting terms in which an employee must work for a company for a specified amount of time before he or she earns the right to buy the options. This vesting term can be thought of as a replacement to a stock option's maturity period. A main difference between RSUs *and stock options is that RSUs do not cost anything to the employee, but a stock option must be bought by a qualifying employee.*

Concept C

Explain briefly the following terms used in Notes 2 and 6: grant date, exercise price, vesting period, expiration date, options/RSUs granted, options exercised, and options/RSUs forfeited or cancelled.

Response*:*

A ***grant date*** *is when the issuance of an award is granted. An* ***exercise price*** *is at which an owner of a trade option is entitled to buy or sell the security presented. A* ***vesting period*** *is the period in which an employee must wait to exercise ESO's. An* ***expiration date*** *is the date in which the ESO expires.* ***Options/RSUs*** *granted is compensation offered by an employer to an employee in the form of company stock.* ***Options exercised*** *is the amount of underlying stock that is put into effect within a contract.* ***RSUs forfeited*** *occurs when an employee leaves a company before the date at which they were able to exercise their grant to stock options.*

Concept D

Consider the information on the employee stock purchase plan (page 63 of Xilinx's annual report). Explain, in your own words, how this plan works. What incentives does this plan provide for Xilinx employees? How do these incentives differ from the incentives created under the employee stock option and RSU plans?

Response:

Under Xilinx's annual report, the employee stock purchase is outlined conceptually and is supplemented with numerical data pertaining to employee participation in this plan. qualified employees can obtain a 24-month purchase right to purchase the Company's common stock at the end of each six-month exercise period. Participation is limited to 15% of the employee's annual earnings up to a maximum of $21 thousand in a calendar year. One of the main incentives to this plan is that employees can purchase company stock at a discounted price. In reference to Xilinx, the purchase price of the stock in this instance is 85% of the lower of the fair market value at the beginning of the 24-month offering period or at the end of each six-month exercise period. Although a significant incentive to a company's ESPP is the idea that stock is purchased at a discount, it can create a risky dynamic internal to the company. Since employees are working for the company in which they hold stock, there is room for concern pertaining to the potential of employee subversion. Specifically, some find concern in the ability for employees to partake in a variety of actions which decreases company stock, thus allowing them to purchase it for a discount more *significant than before. While company employees have to purchase stock under an ESPP, employees do not have to buy RSUs. Under stock options, employees are restricted from buying over 100 shares of underlying stock in most cases, while under an ESPP participation is limited to 15% of an employee's earnings to a maximum of $21 thousand. In some cases, dependent on an employee's fixed salary, an employee may be able to purchase more under an ESPP than* they would under a stock option, or more under a stock option rather than an ESPP.

Concept E

Note 2 describes Xilinx's accounting for stock-based compensation. Describe how Xilinx accounts for employee stock option activity? For RSU activity? For activity under the stock purchase plan?

Response:

Xilinx measures the cost of all employee equity awards that are expected to be exercised based on the grant-date fair value of those awards and to record that cost as compensation expense over the period during which the employee is required to perform service in exchange for the award (over the vesting period of the award). Furthermore, the company is required to record a compensation expense (as previous awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The exercise price of employee stock options is equal to the market price of Xilinx common stock on the date of grant. Additionally, Xilinx's employee stock purchase plan is deemed a compensatory plan under the authoritative guidance of accounting for share-based payment. Accordingly, the employee stock purchase plan is included in the computation of stock-based compensation expense. To recognize stock-based compensation costs over the requisite service period of the award, Xilinx uses a straight-line method to recognize these costs. Upon the cancellation or expiration of stock options, the deferred tax assets for stock options that have multiple vesting dates are eliminated in a first-in, first-out basis.

Process F

Consider Xilinx's 2013 statement of income, statement of cash flows and the table on page 59 of Xilinx's annual report that discloses information about stock-based compensation expense.

Questions

Question 1:

According to the table on page 59, what total expense (before income taxes) does Xilinx report for stock-based compensation in 2013?

Response:

As reported by Xilinx, the total expense before the income tax expense is $77,812 for the first quarter of 2013.

Question 2:

Where on the statement of income does Xilinx include this expense? Explain.

Response:

Referencing the Income Statement, Xilinx includes this expense within the Cost of Goods Sold (listed as Cost of Revenues), Research and Development expenses, and Selling, General, and administrative expenses. On a single-step income statement, all of these expenses would all accumulate under the "Expenses" category. On a consolidated income statement, stock- based compensation included in Cost of Goods Sold of $6,356 would fall right below Net Sales. Stock-based compensation included in Research and Development expenses totaling $37,937 and Selling, General, and Administrative expenses totaling $33,569 would be located under the "Expenses" section of the income statement since Research and Development costs are qualified to be considered Assets, and Selling, General, and Administrative expenses are always considered to be expenses.

Question 3:

How does the 2013 expense affect the statement of cash flows? Describe where the amount of the expense appears in the statement of cash flows.

Response:

With consideration to the Statement of Cash Flows, the "Operating Activities" section of the statement would increase by $55,725. This expense is added to the "Operating Activities" section of the Statement of Cash Flows.

Question 4:

Explain, in general terms, the income tax effects of Xilinx's 2013 stock-based compensation expense.

> ***Response:***
>
> *The tax expense will be recognized when the employee is paid via the stock-based compensation. This methodology is in accordance with standard accounting principle and GAAP guidance which states that income tax expenses are recognized once an item occurs (i.e. employee compensation). The consequence of this methodology is the creation of a tax liability. When time to pay income taxes, the income tax expense will come out of a deferred tax asset account since the taxes will have been paid.*

Question 5:

Prepare the journal entry to record Xilinx's 2013 stock-based compensation expense. Your journal entry should include tax effects.

> ***Response:***

Cost of Goods Sold	6,356	
Research and Development Expense	37,937	
Selling, General, and Admin Expense	33,596	
Accumulated Paid-In-Capital—Stock Option		77,862

Analysis: Part I

Refer to the *Wall Street Journal* article titled "Last Gasp for Stock Options."

Part 1:

What trends does the article discuss in the use of employee stock options and restricted stock awards? Based on the article, which plan do companies find more attractive in recent years? Discuss the reasons for this view. Which plan do you think employees prefer? Why?

> ***Response:***
>
> *Referencing Wall Street Journal article titled "Last Gasp for Stock Options," the very first line states that stock options are "on the verge of extinction" and that many people are moving towards restricted stock awards instead. This swift*

change is attributed to tax-law shifts and the financial crisis, ultimately leaving the options held by employees worthless. According to James Reda, employees and companies find that RSUs are rapidly replacing stock options because they are found to have a more certain return to the employees who hold them. Due to the strike price attributed to stock options, a large risk forms for employees. If the stock doesn't reach the strike price in the future, they become worth almost nothing. Due to this increased risk in comparison to stock options, regardless of a stock option's potential to be a more powerful wealth generator, I believe that many employees will make RSUs their default choice of alternative compensation. Since RSUs and Stock options are simply an additive form of compensation and benefits, it is more logical for an employee to sacrifice the opportunity cost of not investing in a more powerful income generator such as stock options for a more secure and well-founded source of additional income such as RSUs.

Part 2:

Referring to the tables in Xilinx's footnotes that detail stock option grant and RSU grant activity in recent years (pages 62 and 63 of Xilinx's annual report), is the trend in grants of these two forms of stock-based compensation consistent with the trends noted in the article? Cite the information used to support your answer.

Response:

A proper analysis to this question can incorporate multiplicity of interpretations backed by various data from each table and thus is dependent on what data is taken into consideration. If one takes into account the number of shares exercised from 2010 to 2011, which can be considered a valid parameter to determine employee usage of stock options, a decrease of 2,082 shares, or 37%, from 2010 to 2011 is observed. From 2011 to 2012, exercised options decreased by only 58 shares, or 2%. This significant decrease in shares exercised from 2010-2011 (37% drop) and the insignificant decrease in shares exercised in 2011-2012 (2% drop) speaks to the change in employee confidence in stock options. Although the number of shares exercised still decreased from 2011-2012, it only decreased by 2% compared to 37%, thus noting an increase of employees deciding to exercise their options compared to 2010-2011 changes. It is important to consider the time period in which the drop of 2,082 shares exercised occurred. The market in 2010-2011 was still fighting to recover from the recession. By 2011, a slight but noticeable change in market health provided a promising outlook.

My conclusion that is drawn from the large change in the amount of options exercised from 2010 to 2011 and from 2011-2012 can also be correlated with data provided about the amount of options forfeited, canceled, or expired. There is a 40% increase in the number of options forfeited, canceled, or expired from 2010 to 2011, which correlates with the message that the data pertaining to the drop in exercised options from 2010-2011 sends—the idea that (at the time) interest and *confidence in stock options was declining, since employees were forfeiting their options and not paying. From 2011-2012, Xilinx experienced a 58% decrease in stock options forfeited, canceled, or expired. This decline in stock options forfeited, along with the insignificant decrease in the number of stock options exercised from 2011-2012 compared to 2010-2011, predicts that employee confidence in stock options and their usage of stock options began to grow. It is reasonable to assume that this positive increase carried over into 2013-2014 data as the market continued to improve. Therefore, the data Xilinx provided disqualifies the assertion that the presence and usage of stock options within companies is "going extinct."*

Case Study 10

Bier Haus:

A Financial Accounting Study of Revenue Recognition

Part I

Question: How does each step in the five-step revenue model apply to this transaction?

<u>Step 1:</u>

Guidance acquired: *ASC 606-10-05-04*

Identify the contract(s) with a customer—A contract is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in this Topic applies to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, this Topic requires an entity to combine contracts and account for them as one contract. This Topic also provides requirements for the accounting for contract modifications.

Application of ASC 606-10-05-04 to situation:

The contract is identified when the student orders a large plastic cup of beer.

<u>Step 2:</u>

Guidance acquired: *ASC 606-10-05-04*

Identify the performance obligations in the contract—A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Application of ASC 606-10-05-04 to situation:

The performance obligation in this situation is to pour beer and hand it to the student.

<u>Step 3:</u>

Guidance acquired: *ASC 606-10-05-04*

Determine the transaction price—The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Application of ASC 606-10-05-04 to situation:

The transaction price is determined when the bartender tells the student that his order will cost $5.

<u>Step 4:</u>

Guidance acquired: *ASC 606-10-05-04*

Allocate the transaction price to the performance obligations in the contract—An entity typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling prices of each distinct good or service promised in the contract. If a standalone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.

Application of ASC 606-10-05-04 to situation:

Allocation of transaction price to performance obligation: $5

<u>Step 5:</u>

Guidance acquired: *ASC 606-10-05-04*

Recognize revenue when (or as) the entity satisfies a performance obligation—An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation.

Application of ASC 606-10-05-04 to situation:

The revenue is recognized once the performance obligation is completed. The bartender recognizes the revenue when he hands the beer to the student.

Journal Entry for Part I:

Dr. Cash 5
Cr. Sales 5

Part II

Step 1:

Guidance acquired: *ASC 606-10-05-04*

Identify the contract(s) with a customer—A contract is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in this Topic applies to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, this Topic requires an entity to combine contracts and account for them as one contract. This Topic also provides requirements for the accounting for contract modifications.

Application of ASC 606-10-05-04 to situation:

The contract to transfer the beer and mug to the student under a promise for $7

Step 2:

Guidance acquired: *ASC 606-10-05-04*

Identify the performance obligations in the contract—A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Application of ASC 606-10-05-04 to situation:

The performance obligation in this situation is to pour a beer into a large Ole Miss thermal mug and deliver it to the student.

<u>Step 3:</u>

Guidance acquired: *ASC 606-10-05-04*

Determine the transaction price—The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Application of ASC 606-10-05-04 to situation:

The transaction price is $7.

<u>Step 4:</u>

Guidance acquired: *ASC 606-10-05-04*

Allocate the transaction price to the performance obligations in the contract—An entity typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling prices of each distinct good or service promised in the contract. If a standalone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.

Application of ASC 606-10-05-04 to situation:

Allocation of transaction price to performance obligation: $4.37 for beer; $2.63 for the thermal mug.

Step 5:

Guidance acquired: *ASC 606-10-05-04*

Recognize revenue when (or as) the entity satisfies a performance obligation—An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation.

> ***Application of ASC 606-10-05-04 to situation:***
>
> *The revenue is recognized once the performance obligation is completed. The bartender recognizes the revenue when he hands the beer inside the thermal mug to the student.*

Part II Journal Entry:

Cash 7.00		
	Mug Sales	2.63
	Beer	4.37

Part III

Question: How does each step in the five-step revenue model apply to this transaction?

Step 1:

Guidance acquired (Pending): *ASC 606-10-25-2*

Identify the contract(s) with a customer—A contract is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in this Topic applies to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, this Topic requires an entity to combine contracts and account for them as one contract. This Topic also provides requirements for the accounting for contract modifications.

Application of ASC 606-10-25-2 to situation:

The contract identified is for the customer to order beer and a pretzel coupon and for the bartender to perform the obligation for a promised amount.

<u>Step 2:</u>
Guidance acquired: *ASC 606-10-25-2*

Identify the performance obligations in the contract—A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Application of ASC 606-10-25-2 to situation:

Transfer beer and coupon to customer is the performance obligation.

<u>Step 3:</u>

Guidance acquired: *ASC 606-10-05-04*

Determine the transaction price—The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Application of ASC 606-10-05-04 to situation:

The transaction price is determined when the bartender tells the student that his order will cost $7 in total.

Step 4:

Guidance acquired: *ASC 606-10-05-04*
ASC 606-10-25-2

Allocate the transaction price to the performance obligations in the contract—An entity typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling prices of each distinct good or service promised in the contract. If a standalone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.

> ***Application of ASC 606-10-05-04 to situation:***
>
> *Allocation of transaction price to performance obligation: \$2.88 for pretzel coupon; \$4.12 for Beer*

Step 5:

Guidance acquired: *ASC 606-10-25-2*

Recognize revenue when (or as) the entity satisfies a performance obligation—An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation.

> ***Application of ASC 606-10-25-2 to situation:***
>
> *Recognize Revenue: 3.50/8.50= .0412 | 5/8.50=.588 | .0412*7 + .588*7= 7*

Journal Entry for Part III:

Cash	7.00	
Pretzel Coupon		2.88
Beer		4.12

Part IV

Question: How does each step in the five-step revenue model apply to this transaction?

Step 1:

Guidance acquired (Pending): *ASC 606-10-25-2*

Identify the contract(s) with a customer—A contract is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in this Topic applies to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, this Topic requires an entity to combine contracts and account for them as one contract. This Topic also provides requirements for the accounting for contract modifications.

> ***Application of ASC 606-10-25-2 to situation:***
>
> *The contract identified is that the customer two pretzels. The bartender will perform the obligation for a promised amount of $4.*

Step 2:

Guidance acquired: *ASC 606-10-25-2*

Identify the performance obligations in the contract—A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

> **Application of *ASC 606-10-25-2 to situation:***
>
> *The performance obligation is to transfer two pretzels to the customer.*

Step 3:

Guidance acquired: *ASC 606-10-05-04*

Determine the transaction price—The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Application of ASC 606-10-05-04 to situation:

The transaction price is determined when the bartender tells the student that his order will cost $4 in total.

<u>Step 4:</u>

Guidance acquired: *ASC 606-10-05-04*

Allocate the transaction price to the performance obligations in the contract—An entity typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling prices of each distinct good or service promised in the contract. If a standalone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.

Application of ASC 606-10-05-04 to situation:

Allocation of transaction price to performance obligation: $3.50 is the coupon transaction price; the allocated price already accounted for is $2.88.

<u>Step 5:</u>

Guidance acquired: *ASC 606-10-25-2*

Recognize revenue when (or as) the entity satisfies a performance obligation—An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation.

Application of ASC 606-10-25-2 to situation:

Recognize Revenue: Recognize $4.00 for revenue

<u>Journal Entry for Part IV:</u>

Unearned Service Revenue	2.88	
Discount	1.12	
Pretzel sales		1.12

Case Study 11

ZAGG, Inc. – Deferred Income Taxes:

A Financial Accounting Study of Deferred Income Taxes

A. Describe what is meant by the term book income? Which number in ZAGG's statement of operation captures this notion for fiscal 2012? Describe how a company's book income differs from its taxable income.
    - Book income is the equivalent to financial income. Financial income is calculated by taking revenues and subtracting the expenses from them. This is contrasted from taxable income due to temporary, permanent, and loss carryforwards and carrybacks.

B. In your own words, define the following terms:
    - Permanent tax differences (also provide an example):
        i. A permanent difference is a business transaction that is reported differently for financial and tax reporting purposes, and for which the difference will never be eliminated. A permanent difference that results in the complete elimination of a tax liability is highly desirable since it permanently reduces the tax liability of a business. Consequently, it is a key goal of tax planning. An example would be meals and entertainment, in which these expenses are only partially recognized for tax reporting purposes.
    - Temporary tax difference (also provide an example):
        i. A temporary tax difference is the difference between the carrying amount of an asset or liability on the campus balance sheet and the asset or liability taxable base. There are two types of temporary tax differences; deductible or taxable. For example, depreciation is accounted for differently on book income versus taxable income.
    - Statutory tax rate
        i. This is the rate imposed by the state or country that is responsible for taxing the entities.
    - Effective tax rate
        i. The effective tax rate is the average rate at which an individual or corporation is taxed. The effective tax rate for individuals is the average rate at which their earned income is taxed, and the effective tax rate for a corporation is the average rate at which its pre-tax profits are taxed.

C. Explain in general terms why a company reports deferred income taxes as part of their total income tax expense. Why don't companies simply report their current tax bill as their income tax expense?
    - These deferred taxes are incurred during the period and therefore should be included in total income tax expense to satisfy the matching principle.

D. Explain what deferred income tax assets and deferred income tax liabilities represent. Give an example of a situation that would give rise to each of these items on the balance sheet.
    - Deferred tax assets represent a positive cash inflow while a deferred tax liability represents a tax payment that the company must make in the future. An example of this would be the carry-over losses; as an example of a deferred tax liability is depreciation differences for taxable income and book income.

E. Explain what a deferred income tax valuation allowance is and when it should be recorded.
    - The deferred income tax valuation allowance is a provision relating to the deferred tax asset to ensure that the deferred tax asset is not overstated.

F. Consider the information disclosed in Note 8 – Income Taxes to answer the following questions:
    - Using information in the first table in Note 8, show the journal entry that ZAGG recorded for the income tax provision in fiscal 2012?

Net Income Expense	9,393.00	
Net Deferred Tax Asset	8,293.00	
Income Tax Payable		17,686.00

    - Using the information in the third table in Note 8, decompose the amount of "net deferred income taxes" recorded in income tax journal entry in part f. i. into its deferred income tax asset and deferred income tax liability components.

Income Tax Expense	9,393.00	
DTA	8,002.00	
Deferred Tax Liability	291.00	
Income Tax Payable		19,686.00

    - The second table in Note 8 provides a reconciliation of income taxes computed using the federal statutory rate (35%) to income taxes computed

ETR= Tax Expense / Pre-Tax Income

ETR= 9393 / 23898 = 39.3%

The permanent differences between book income and taxable income make up the 4.3% difference of the effective tax rate and the statutory tax rate.

using ZAGG's effective tax rate. Calculate ZAGG's 2012 effective tax rate using the information provided in their income statement. What accounts for the difference between the statutory rate and ZAGG's effective tax rate?

The current portion of deferred income tax assets is listed under current assets as 6,912, while the non-current portion is listed as an asset on the balance sheet.

Case Study 12

Xilinx, Inc.—Stock Based Compensation:

A Financial Accounting Study of Stock-Based Compensation

A. Why do companies lease assets rather than buy assets?

- ***100% Financing at fixed rates-*** Leases are often signed without requiring any money down from the lessee. This helps the lessee conserve scarce cash—an especially desirable feature for new and developing companies. In addition, lease payments often remain fixed, which protects the lessee against in inflation and increases in the cost of money.

- ***Protection against obsolescence -*** Leasing equipment reduces risk of obsolescence to the lessee and in many cases, passes the risk of residual value to the lessor

- ***Flexibility -*** Lease agreements may contain less restrictive provisions than other debt agreements. Innovative lessors can tailor a lease agreement to the lessee's special needs. For instance, the duration of the lease—the lease term—may be anything from a short period of time to the entire expected economic life of the asset. The rental payments may be level from year to year, or they may increase or decrease in amount. The payment amount may be predetermined or may vary with sales, the prime interest rate, the Consumer Price Index, or some other factor. In most cases, the rent is set to enable the lessor to recover the cost of the asset plus a fair return over the life of the lease.

- ***Less costly financing -*** Some companies find leasing cheaper than other forms of financing. For example, start-up companies in depressed industries or companies in low tax brackets may lease to claim tax benefits that they might otherwise lose. Depreciation deductions offer no bene t to companies that have little if any taxable income. Through leasing, the leasing companies or financial institutions use these tax benefits. They can then pass some of these tax benefits back to the user of the asset in the form of lower rental payments.

- ***Tax advantages -*** For financial reporting purposes, companies do not report an asset or a liability for the lease arrangement. For tax purposes, however, companies can capitalize and depreciate the leased asset. As a result, a company takes deductions earlier rather than later and also reduces its taxes

- ***Off-balance-sheet financing -*** Certain leases do not add debt on a balance sheet or affect financial ratios. In fact, they may add to borrowing capacity. Such off-balance- sheet financing is critical to some companies.

B. What is an operating lease? What is a capital lease? What is a direct-financing lease? What is a sale- type lease? (*Hint*: If your textbook does not cover these lease complexities, use your favorite Internet search engine to find definitions and examples.)

- An operating lease is a contract in which an asset is allowed to be used but doesn't allow the ownership rights of an asset. It is a representation of off-balance sheet financing of assets.
- A capital lease is a contract which entitles a renter to a temporary use of an asset. It has the economic characteristics of asset ownership for accounting purposes. It requires a renter to add assets and liabilities with the lease if the rental contract meets specific requirements.
- A direct-financing lease is essentially the coupling of a sale and financing transaction. In this case, the lessor removes the leased asset from its books and replaces it with a receivable from the lessee.
- A sale-type lease is accounted for like a direct-financing lease, except that profit on a sale is recognized upon inception of the lease, in addition to the interest income recognized during the lease term. The gross profit recognized at the inception of the lease is the PV of all lease payments minus the cost of the leased asset.

C. Why do accountants distinguish between different types of leases?

- Accountants mainly distinguish between different types of leases due to issues with classification.

D. Consider the following hypothetical lease for a Build-A-Bear Workshop retail location.
- Will this lease be treated as an operating lease or a capital lease under current U.S. GAAP?
    - It will be treated as an operating-lease
- Provide the journal entry that Build-A-Bear Workshop will record when it makes the first lease payment.

Lease Expense	100,000	
Cash		100,000

- Assume that a second lease is identical to this lease except that Build-A-Bear Workshop is offered a "first year rent-free." That is, the company will make no cash payment at the end of year one but will make payments of $125,000 at the end of each of years 2 through 5. Provide the journal entries that the company will make over the term of this lease.

Lease Expense	100,000	
Lease Payable	25,000	
Cash		125,000

F.

I.

	Payments	Present Value Factor	Present Value
1	50,651.00	0.9346	47,337.38
2	47,107.00	0.8734	41,145.08
3	42,345.00	0.8163	34,566.13
4	35,469.00	0.7629	27,059.13
5	31,319.00	0.7130	22,330.01
6	25,229.00	0.6663	16,811.15
7	25,229.00	0.6227	15,711.35
8	25,229.00	0.5820	14,683.51
			219,643.75

II.

Property, Plant, Equipment	219,643.75	
Lease obligation		219,643.75

The purpose of this journal entry is to add the leased asset onto Build-A-Bear's books in conjunction with a corresponding payable.

III. N/A

V. What journal entries would the company record in fiscal 2010 for these leases, if they were considered capital leases?

Lease Obligation	15,375.06	
Interest Expense	35,275.94	
Cash		50,651

Depreciation Expense	27,455. 47	
Accumulated Depreciation		27, 455.47

*Depreciation Expense= (219,643.75/8)

E.

Consider Build-A-Bear Workshop's operating lease payments and the information in Note 10, Commitments and Contingencies. Further information about their operating leases is reported in Note 1, Description of Business and Basis of Preparation (k) Deferred Rent.

- What was the amount of rent expense on operating leases in fiscal 2009?
    - Build-A-Bear Workshop reported $45.9 Million worth of rent expense.
- Where did that expense appear on the company's income statement?
    - This expense would appear under the Operating Section of the Income Statement.

G.

Under current U.S. GAAP, what incentives does Build-A-Bear Workshop, Inc.'s management have to structure its leases as operating leases? Comment on the effect of leasing on the quality of the company's financial reporting.

H.

If Build-A-Bear had capitalized their operating leases as the FASB and IASB propose, key financial ratios would have been affected.

Refer to your solution to part *f*, above to compute the potential impact on the current ratio, debt-to-equity ratio (defined as total liabilities divided by stockholders' equity) and long-term debt-to-assets ratio (defined as long-term debt divided by total assets) at January 2, 2010. Is it true that the decision to capitalize leases will always yield weaker liquidity and solvency ratios?

2.Refer to the Build-A-Bear income statement for the 13-week quarter ended April 3, 2010. Compute the potential impact of lease capitalization on return on equity and return on assets for the quarter. Assume that lease payments and the amortization and interest expenses you computed for fiscal 2010 in part *f.v*, above, were incurred evenly over fiscal 2010. Also, assume a marginal tax rate of 35%. For simplicity, use the balance sheet numbers at January 2, 2010 in the denominator of both return ratios, rather than averages.